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PP RUEHDBU
DE RUEHTA #1243/01 1281033
ZNY CCCCC ZZH
P 081033Z MAY 07
FM AMEMBASSY ASTANA
TO RUEHC/SECSTATE WASHDC PRIORITY 9396
INFO RUCNCIS/CIS COLLECTIVE 0156
RUCPDOC/DEPT OF COMMERCE WASHDC
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C O N F I D E N T I A L SECTION 01 OF 06 ASTANA 001243

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DEPT FOR EB/ESC; SCA/CEN (O'MARA)

E.O. 12958: DECL: 03/15/2017

TAGS: [ECON](#) [EPET](#) [ETRD](#) [PGOV](#) [KZ](#)

SUBJECT: KAZAKHSTAN: MERMOUD DISCUSSES PUBLIC-PRIVATE PARTNERSHIP AND ASTANA'S PUSH FOR DIVERSIFICATION

REF: A. A) ASTANA 1240

[1](#)B. B) ASTANA 1122

[1](#)C. C) 06 ASTANA 150

[1](#)D. D) ASTANA 753

Classified By: CDA Kevin Milas; reasons 1.4 (b) and (d).

[1](#)1. (C) Summary. In April 24-26 meetings with Prime Minister Masimov, other Kazakhstani government officials, and private sector representatives, Special Representative for Commercial and Business Affairs J. Frank Mermoud discussed the Kazakhstani government's fast-evolving approach to economic diversification and opportunities for bilateral engagement in the framework of the Public-Private Partnership Initiative. Masimov outlined the GOK's latest plans to shift its focus away from further development of the oil sector toward domestically-driven diversification. He presented the new &30 corporate leaders of Kazakhstan's strategy, the GOK's own public-private initiative, and expressed interest in exploring ways to create links with the proposed U.S. initiative. Representatives of the private sector emphasized tax and customs administration, along with a rule of law deficit, as key obstacles to sustainable business and economic development. They expressed hope that the Public-Private Partnership Initiative can become a vehicle for addressing these concerns. Ref A reports Masimov's and Sagadiyev's remarks on the GOK's current plans for the oil sector. Please see action request in paragraph 25. End summary.

[1](#)2. (SBU) Special Representative Mermoud met the following representatives of the Kazakhstani government and the business sector:

April 24:

-- Raimbek Batalov, President of the Forum of Entrepreneurs
-- Arman Moldakhetov, Vice President of the National Innovation Fund
-- Courtney Fowler, Partner - Pricewater House Cooper
-- Kenneth Mack, Partner - Chadbourne & Parke, President of the American Chamber of Commerce

April 25:

-- Serik Akhmetov, Chairman of the Association of Financiers of Kazakhstan
-- Yerlan Sagadiyev, Advisor to the Prime Minister
-- Nurlan Kapparov, President of KazInvest Bank

April 26:

-- Azat Peruashev, President of the &Atameken8 Union of Entrepreneurs
-- Ulf Wokurka, Deputy Chairman & CFO of Samruk State Holding

Co.

-- Karim Masimov, Prime Minister
-- Alikhan Smailov, Chairman of Managing Board) &KazAgro8
National Holding Co.
-- Askar Batalov, Vice Minister of Industry & Trade
-- Serik Akhmetov, Minister of Transport & Communications

Shifting Focus Away from Oil(

¶3. (C) On April 26, Prime Minister Masimov provided Special Representative Mermoud and the Ambassador with some background on the GOK,s current economic thinking. President Nazarbayev, Masimov said, attached a lot of importance to economic diversification even in the early days of Kazakhstani independence. &Back then,8 Masimov mused, &we were hoping for a Marshall Plan.8 &Unfortunately,8 he continued, Kazakhstan is &most interesting8 to foreign investors as a supplier of oil, not &other things.8 Now, the Prime Minister stated, the government has decided to take action into its own hands. &Before, we focused on selling natural resources. Now we want to sell products.8

¶4. (C) In an earlier meeting, Masimov,s Advisor Yerlan Sagadiyev expressed the view that the GOK,s spending of its oil windfall is crowding out the desired private investment in the non-extractive sector. Kazakhstan,s corporations, he said, are directing their investment abroad as they flee the uncertainty created by the GOK,s heavy-handed involvement in a wide range of sectors. He explained that the challenge is to delineate the separation of the government,s and the private sector,s roles in the economy. The idea, Sagadiyev stated, is for the state to inform the private sector what it will do and what the state expects from the private sector.

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And Toward a New Vision: the Thirty Corporate Leaders

¶5. (C) The new plan, Masimov explained, rests on a Kazakhstani-driven pursuit of diversification. The idea is to appoint 30 domestic corporations as &corporate leaders8 or &national champions8 and entrust them with large-scale investment projects. &Our financial system is strong and lets us take much of the risk ourselves,8 Masimov stated, &(what we need (from abroad) is the know-how.8 The three areas of focus, he said, are education, healthcare, and transportation infrastructure.

¶6. (C) Sagadiyev provided some of the practical details. On April 20, President Nazarbayev met with some of the top representatives of the Kazakhstani business world (Ref B). The meeting was a prelude to the identification of 30 large-scale investment projects to be assigned to these corporate leaders. &Thirty,8 explained Masimov to S/R Mermoud and the Ambassador, &is because twenty is too few, and forty is too many.8 Vice Minister of Industry and Trade Askar Batalov told S/R Mermoud that each project will range in size from \$500 million to \$1 billion. (Note: According to a posting on the Presidential Administration website, each project will have a minimum implementation cost of \$100 million. End note.)

¶7. (C) The next steps, Sagadiyev explained, are for the government to identify the 30 corporate leaders and have relevant ministries sign memoranda of understanding with them. &Not all ministries,8 Sagadiyev remarked, &are sincere in pursuing in this.8 The plan, then, is to start with two: Industry and Trade, and Agriculture. Sagadiyev added that it was his job to find the corporate champions: &it has been five days, and we have been traveling heavily.8 He alluded repeatedly to using Britain,s privatization experience as a guide in pursuing this vision and, particularly, in drafting the MOUs: &we have a sample from Britain signed by Thatcher during energy

privatization.⁸ The first MOU is to be signed in about a month. U.S. consultants, Sagadiyev added, are being used extensively in implementing this vision, including on the issue of the public-private partnership.

A Role for Foreign Investors?

¶ 8. (C) While presenting his government's new economic plan as partly a reaction to the failure of foreign investors to sufficiently embrace opportunities existing in Kazakhstan's non-extractive sector, Masimov stressed the vision's welcoming orientation toward foreign participation. &We will have open, clean tenders,⁸ he assured S/R Mermoud and the Ambassador. &If foreign investors are interested, they are more than welcome,⁸ continued Masimov, and &if not, that's okay.⁸ But, he concluded, &conferences and good economic relations are not enough.⁸ Sagadiyev took the same results-oriented approach: &We are seeking specific projects. We have passed the stage of understanding; we need to do things.⁸ Masimov cited GE's locomotive-building operation near Astana and the Fed Ex operations in Almaty as the kind of &good projects⁸ the GOK is seeking.

¶ 9. (C) Both Masimov and Sagadiyev expressed appreciation for the potential role that the U.S. technical expertise could play. &We do not have enough experience and technology; this is where we are looking for Western participation,⁸ stated Masimov. He called the U.S. &number one⁸ in technology and economic development and pointed out two specific areas with particular promise for collaboration: agriculture (&very good discussions with Secretary Johanns⁸) and alternative energy. Sagadiyev explained that current electricity tariffs, &a killer⁸ to alternative energy, will be increased. &At 7-8 cents (per kw/hr),⁸ he mused, &alternative energy will make sense.⁸ The U.S., he added, is &quite advanced⁸ in this area.

¶ 10. (C) Batalov also emphasized that the plan presents an invitation to foreign investors, describing the identification of 30 domestic leaders as a &signal⁸ to foreign companies of who their Kazakhstani partners should be. He also mentioned the idea of creating consortia with the participation of international financial institutions (IFI's) and the notion that private companies are better vehicles for conducting tenders than the government. The

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thirty leaders will choose their partners among domestic and foreign companies. Furthermore, Batalov stressed, Kazakhstan's Law on Investments provides the same legal treatment to foreign and domestic investors. Still, Batalov was clear about the strong domestic orientation of the GOK's current vision: &This is about proposing to domestic companies projects that would, in the past, be offered to foreign investors(The thirty will take the projects. This is what protectionism is.⁸

¶ 11. (C) Batalov was both candid and vague on the precise relationship the government will have with the corporate leaders. He echoed Sagadiyev's description of a quid pro quo arrangement in which the government provides &facilitation⁸ (e.g. engineering platforms, the legislative base, WTO accession), and the &leaders⁸ will commit to carrying out their projects. He mentioned another reason for entrusting the &breakthrough projects⁸ exclusively to domestic companies. &We cannot tell foreign investors, go there and do this,,⁸ stated Batalov, &but we can say this to domestic companies.⁸ He summed up the philosophy of the vision as &ninety percent economics, ten percent national pragmatism.⁸ Batalov acknowledged S/R Mermoud's cautionary note on the risk of creating monopolies. &We are familiar with the experience of South Korean chaebols as well as the British experience,⁸ Batalov said. Describing the South Korean scenario as &too extreme,⁸ he remarked, &we will be somewhere in the middle.⁸

¶12. (C) The themes raised by GOK officials had little in common with the concerns S/R Mermoud consistently heard from representatives of the Kazakhstani private sector. Raimbek Batalov, President of the Forum of Entrepreneurs) an Almaty-based NGO which positions itself as the genuine national voice of small- and medium-sized business as well as regional and industry business associations) outlined four government failures as the primary obstacles to economic and business development in today,s Kazakhstan. The GOK,s key failures, Batalov said, are in the areas of tax policy, customs policy, rule of law, and trade policy. (Note: Raimbek Batalov is not known to be related to Vice Minister Batalov. His focus on trade policy appears to stem from his role as the CEO of a major retail chain. End note.)

¶13. (C) These policy and enforcement failures, according to Batalov, are driving an untold portion of the country,s economic activity into the shadow economy. Much of the trend, Batalov explained, starts at Kazakhstan,s borders. A regulatory loophole for small- and medium-sized businesses, combined with customs officials, notoriously corrupt ways, leads to a situation where most goods entering Kazakhstan do so &under the radar.⁸ Importers break up their wares into smaller portions and &misdeclare⁸ them at the customs control, relying on the customs officials, incompetence and venality. Thus escaping the tariff system, such goods directly proceed to enter Kazakhstan,s shadow economy via bazaars, where they reach the consumer without ever being subjected to taxation, standardization or other regulations. (Note: In September 2006, Lubov Khudova, Chairwoman of Kazakhstan,s Light Industry Association, described to Econoff precisely the same phenomenon and partly blamed it for the spectacular decline of Kazakhstan,s textile manufacturing. Ref C. End note.) Batalov concluded that the Business Forum,s research indicates that over 60% of all business activity in Kazakhstan takes place in the shadow economy, far above official estimates of 24%.

¶14. (C) Courtney Fowler, Partner of Price Waterhouse Coopers, and Kenneth Mack, Partner at Chadbourne & Park and President of AmCham Kazakhstan, firmly confirmed Batalov,s emphasis on corruption as the key impediment to business development in Kazakhstan. Fowler stressed that tax administration) marred by corruption, incompetence, and a lack of proper accounting practices) places a tremendous burden on business. On the corporate side, she told S/R Mermoud, the situation is also troubling. It is common for companies to keep two sets of (unmatching) books) one for accounting purposes, the other for taxes. Heads of auditing departments, Fowler added, are frequently not accountants, let alone auditors. Echoing Batalov,s message on the shadow economy, she remarked that &no one bats an eye when you pay for something with \$200,000 cash.⁸ Fowler lamented the GOK,s failure to address the &systemic⁸ issues and cited

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the rule of law deficit as a major problem: &if foreign investors cannot trust their Kazakhstani partners,⁸ she mused, &Kazakhstan will never achieve diversification.⁸

¶15. (C) Serik Akhanov, Chairman of the Association of Financiers of Kazakhstan, presented to S/R Mermoud a rather optimistic view of the country,s financial system and macroeconomic situation. He named inflation as a principal macroeconomic risk but stressed that the central bank remains watchful in guarding against it. He stated that the Kazakhstani private sector,s mushrooming external borrowings are creating a vulnerability to external shocks, particularly to rising interest rates, but explained that Kazakhstan,s financial institutions are turning abroad due to a lack of long-term capital at home. While lauding Kazakhstan,s banking sector as highly developed and operating on par with

international standards, Akhanov said that the insurance and pension industries continue to lag. He appeared largely unperturbed by the rapid expansion of the real estate sector, saying that only the top 2% of the housing market was showing significant signs of speculative activity.

Inside the State Holding Companies

¶16. (C) Arman Moldakhmetov, Vice President of the National Innovation Fund (NIF), briefed S/R Mermoud on the Fund's approach to spurring diversification. The NIF is a component of the Kazyna Fund for Sustainable Development, a state holding company currently encompassing 14 development institutions. The NIF's model is based on equity participation in high-tech, &knowledge-economy8 projects. This participation ranges up to 49% ownership, since) Moldakhmetov explained) &we do not want to manage.8 The NIF sees its key role as bringing together the government, the academia, and the corporate sector. &Kazakhstan,8 he remarked, &is full of money. The shortage is of good projects.8 Moldakhmetov mentioned the NIF's involvement in three &technoparks8 established in Uralsk, Karaganda, and Almaty to provide infrastructure for entrants into the knowledge economy. These, he said, &are not doing well. There is furniture, nothing else. No one is working.8

¶17. (C) Samruk State Holding Company CFO Ulf Wokurka briefed S/R Mermoud on Samruk activities within the framework of the holding companies, &three principal activities8: improving corporate governance, helping to develop Kazakhstan's domestic capital market, and facilitating &select investment opportunities.8 Expanding on the third topic, Wokurka explained that in May, Samruk would establish a fully-owned &investment subsidiary,8 which would coordinate targeted infrastructure projects, addressing such issues as project finance, until the point in which the projects could be &handed over8 to interested private or state entities. Wokurka mentioned the construction of a combined heat and power plant near Balkash (Ref D) as an example.

¶18. (C) Wokurka explained that in order to facilitate development of a domestic capital market, the Prime Minister had directed Samruk, along with the other state-holding companies, to develop further candidate companies for IPOs, in accordance with the rules establishing the Almaty Regional Financial Center. To this end, Wokurka said, Samruk was steering its companies toward financing by means of debt instruments, in addition to the more-customary commercial loans. Wokurka told S/R Mermoud that Samruk's next IPO (of the Mangistau oblast electrical grid operator) would occur in late 2007. The GOK had planned to transfer to Samruk another fifteen companies, Wokurka said, but Samruk had asked that the transfer be delayed while the holding company better assimilated its existing holdings. Wokurka also confirmed that a new company, &Samruk Energy,8 would soon be established to manage Samruk's five power generating companies.

¶19. (C) Alikhan Smailov, Chairman of the Managing Board of the newly created state agricultural holding company &KazAgro,8 briefed S/R Mermoud on his organization's plans. KazAgro, he explained, currently incorporates seven of the GOK's agricultural companies, whose missions range from intervention in grain markets to providing microcredits to rural communities to purchasing and reselling livestock products. KazAgro's overall mission, Smailov said, is to manage the state's agricultural assets in accordance with corporate management standards as well as national goals.

&is our approach, and it has been approved by the Prime Minister.⁸

¶20. (C) Smailov spoke extensively about KazAgro,s plans in the ethanol market. The vision is to construct bioethanol plants to produce ethanol for export and achieve production levels of 3 billion liters per year. Large-scale beef and dairy farms are also planned, and KazAgro is expanding grain export infrastructure by building terminals on the Caspian. He noted that KazAgro is seeking foreign investors, interest in these projects, particularly in bioethanol. What is needed from foreign partners, Smailov said, is &modern equipment at reasonable prices⁸ and help with marketing these products abroad.

Prospects for the Public-Private Partnership

¶21. (C) S/R Mermoud received wide-ranging input from his interlocutors on the possible directions of the bilateral Public-Private Partnership Initiative (PPPI). Masimov expressed an interest in proceeding with the Initiative. He named Sagadiyev as the primary Kazakhstani interlocutor on the issue and suggested that Sagadiyev travel to Washington in June to explore the avenues the PPPI may take. Minister of Transport Serik Akhmetov told S/R Mermoud that his ministry has a great interest in developing international contacts and attracting foreign investment. The \$30 billion Transportation Strategy passed last year, Akhmetov said, provides for some of the funding to come from &non-budget⁸ sources, such as foreign investment.

¶22. (C) Business sector representatives (Fowler, Mack, and the Forum,s Raimbek Batalov) focused on the PPPI,s potential in addressing the &systemic⁸ issues (e.g. tax and customs administration, the rule of law) currently getting short shrift from the GOK. Batalov and Mack, in particular, expressed a strong interest in establishing collaboration between the Entrepreneurs Forum and the AmCham. Both Batalov and Mack held the view that organizing a discussion of) and proposing solutions to)&systemic⁸ issues in a PPPI forum could spur the GOK to much-needed action. Fowler suggested building links between U.S. and Kazakhstani business schools as a way to rectify the shortage of management expertise. The Financiers Association,s Akhanov likewise expressed interest in fostering exchanges among corporate leaders at varying levels. The Innovation Fund,s Moldakhmetov offered to provide input on any future plans or ideas in the context of the PPPI. Azat Perushev, Chairman of the&Atameken⁸ Union of Entrepreneurs, which purports to be Kazakhstan,s official national business association, expressed a strong interest in building links with U.S. counterparts.

Comment

¶23. (C) The fact that the proposed bilateral PPPI coincides with the GOK,s own public-partnership program presents opportunities as well as potential challenges. The GOK,s new approach is unapologetically focused on domestic companies and highly results-oriented. Kazakhstani officials, underlying question seems to be: how can the PPPI fit into Kazakhstan,s own public-private program and what concrete results (i.e. investment commitments) can it bring in the foreseeable future? The GOK,s intensity may be partly explained by practical considerations: Masimov recently told Ambassador Ordway that his government will only have two to three years to achieve its goals.

¶24. (C) The GOK,s &30 corporate leaders⁸ program, while an outgrowth of the macroeconomically sound desire to diversify the economy away from the extractive sector, is fraught with risks. Without proper safeguards, the vision may well lead to creation of more monopolies, a phenomenon already plaguing a range of key economic sectors such as telecommunications and civil aviation. In any case, the policy signals the GOK,s continued adherence to a &top-down⁸ approach to economic diversification and an apparent lack of urgency in

confronting the &systemic8 issues that are the main concerns of the business sector. Notably, the business representatives, hopes for the PPPI were that the Initiative would specifically address the problems the GOK is continuing

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to ignore. End comment.

¶25. (SBU) Action request: Post requests Department guidance regarding next steps on the Public-Private Partnership Initiative, as well as clarification of which office will have the lead.

¶26. (U) This cable has been cleared by S/R Mermoud.
MILAS